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Department of the Treasury

Washington, DC 20224

[Third Party Communication:

Date of Communication: Month DD, YYYY]

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B01

PLR-155735-05

Date:

January 26, 2007

Legend:

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Dear :

This is in reply to a letter dated November 2, 2005, and subsequent correspondence, requesting the following rulings (as modified).

(1) Taxpayer's specific identification of hedges entered into prior to Date 1, does not in and of itself preclude Taxpayer from identifying qualifying derivatives entered into on or after such date as hedges of aggregate interest rate risks with respect to Taxpayer indebtedness.

(2) To the extent that the hedging transactions are in fact qualifying hedges of the type identified, the hedging identification statement placed in Taxpayer's books and records on Date 1, as supplemented, will be treated as satisfying the identification requirements of § 1221 of the Internal Revenue Code and § 1.1221-

2(f) of the Income Tax Regulations for aggregate hedges entered into on or after Date 1, and on or prior to Date 2.

(3) Taxpayer is not precluded by the singular use of the term “liability” in § 475(b)(1)(C)(ii) from identifying as exempt under § 475(b)(2) otherwise qualifying hedges of “liabilities” which are not securities in the hands of Taxpayer.

Facts:

Taxpayer issues various types of debt to finance its acquisition of mortgage assets. In order to manage the risk of interest rate changes, price changes and/or currency fluctuations with respect to its debt portfolio, the Treasurer’s Office of Taxpayer enters into derivative transactions.

Through Date 3, Taxpayer identified each derivative on the day it was entered into as a hedge of particular debt instruments or anticipated debt issuances for purposes of § 1.1221-2(b) and § 475(b)(1)(C). On Date 1, Taxpayer placed in its books and records a statement identifying all derivative transactions to be entered into through its Treasurer’s Office as hedges for tax purposes of the aggregate risk of interest rate changes, price changes, and/or currency fluctuations with respect to debt issued or to be issued by Taxpayer.

The Date 1, identification statement provides that the derivatives entered into by the Treasurer’s Office as hedges of aggregate risk include interest rate swaps, basis swaps, forward starting swaps, caps, swaptions, and currency derivatives. Taxpayer represents that the identification statement was also intended to include floors. Taxpayer represents that the identification statement was not intended to include, and does not include, any of the following transactions:

- Derivatives relating to the value of any commodity (including a commodity as defined in § 475(e)(2));
- Debt instruments, including structured notes (i.e., debt instruments containing embedded derivatives);
- Sale-repurchase transactions (“repos”);
- Options to enter into long positions with respect to indebtedness (i.e., options entitling Taxpayer to acquire positions that economically represent investments in debt);
- Mortgage-backed securities options;
- Credit default swaps;
- Asset swaps; and
- Forward commitments to purchase mortgages.

The identification statement provides that Taxpayer does not engage in trading or take speculative positions with derivatives or other financial instruments.

In addition, Addendum 1 to the identification statement provides that the identification does not include any derivative transactions entered into pursuant to Taxpayer's

Taxpayer's describes in greater detail the specific types of derivative transactions used to hedge the risk described in the identification statement. Taxpayer's describes Taxpayer's exposure to foreign currency fluctuations with respect to debt it issues. The Derivatives Risk Policy states at page nine that Taxpayer only uses foreign currency derivatives to offset economically exposures from specific debt issues and that foreign currency denominated debt are completely hedged with currency swaps within the same day.

Taxpayer is a dealer in securities within the meaning of § 475(c)(1). Thus, Taxpayer is generally subject to the mark-to-market rules in § 475(a) with respect to securities held by it except where eligible for exemption.

Law and Analysis:

Section 1221(a)(7) provides a capital asset does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into. Section 1221(b)(2)(A) and § 1.1221-2(b) define a hedging transaction to include any transaction entered into by a taxpayer in the normal course of the taxpayer's trade or business primarily to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. The term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings. § 1.1221-2(c)(3).

It is not enough, however, for a transaction to be a hedging transaction in fact. Section 1.1221-2(f) provides the identification and recordkeeping requirements that must be met for a transaction to be treated as a hedging transaction. A taxpayer must clearly identify a hedging transaction before the close of the day on which the taxpayer entered into the transaction and must identify the item, items, or aggregate risk being hedged substantially contemporaneously. § 1.1221-2(f)(1) and (2). Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. Id. In addition, if the taxpayer in fact hedges aggregate risk, the identification must include a description of the risk being hedged and the program under which the hedging transaction was entered. § 1.1221-2(f)(3)(iv). This requirement may be satisfied by placing a description of the hedging program in the taxpayer's records and by establishing a system under which individual transactions

can be identified as being entered into pursuant to the hedging program. Id. A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. § 1.1221-2(f)(3)(iv)(B). If the program contains controls on speculation, the description of the hedging program must also explain how the controls are established, communicated, and implemented. Id.

Section 1.1221-2(f)(4) provides the identification must be made on and retained as part of the taxpayer's books and records, and the presence of an identification must be unambiguous. A taxpayer is permitted to establish a system under which identification is indicated by the type of transaction or by the manner in which the transaction was consummated or recorded. § 1.1221-2(f)(4)(iii). For example, the taxpayer can record a statement in its books and records that all future transactions in a specified derivative product are hedges of a specified item, items, or aggregate risk. § 1.1221-2(f)(4)(iv)(B).

The identification and recordkeeping requirements are necessary for the Service to locate and evaluate transactions that taxpayers believe should qualify for hedge treatment. T.D. 8493 (October 20, 1993). In particular, the requirement of identifying the item being hedged is needed to establish that the definition of hedging transaction is satisfied. T.D. 8555 (July 18, 1994). Section 1.1221-2(g) contains rules addressing the effect of misidentifying hedges.

Section 475 provides mark-to-market accounting rules for dealers in securities. Section 475(a)(1) provides that any security which is inventory in the hands of the dealer shall be included in inventory at its fair market value. Section 475(a)(2) provides that in the case of any security which is not inventory in the hands of the dealer and which is held at the close of any taxable year the dealer shall recognize gain or loss as if such security were sold for its fair market value on the last business day of such taxable year, and any gain or loss shall be taken into account for such taxable year.

Section 475(b) sets forth exceptions from the § 475 mark-to-market rules. Section 475(b)(1)(C) exempts from § 475(a) mark-to-market treatment any security which is a hedge with respect to a security to which subsection (a) does not apply, or a position, right to income, or a liability which is not a security in the hands of the taxpayer.

Section 7701 sets forth definitions and other rules that generally apply in interpreting the Code. Section 7701(o)(1)(1) cross references 1 U.S.C § 1 for the statutory rule of construction with regard to singular terms. Section 1 provides, in part, that in determining the meaning of any Act of Congress, unless the context indicates otherwise, words importing the singular include and apply to several persons, parties, or things. Taxpayer claims to hedge several things (i.e., aggregate debt liabilities) with

each qualifying hedge. So long as those things in fact hedged are liabilities which are not securities in the hands of Taxpayer, there is no evident reason to restrict the language of § 475(b)(1)(C)(ii) to hedges of a single liability.

Conclusions:

Based on the information submitted and representations made, we conclude the following.

(1) Taxpayer's specific identification of hedges entered into prior to Date 1, does not in and of itself preclude Taxpayer from identifying qualifying derivatives entered into on or after such date as hedges of aggregate interest rate risks with respect to Taxpayer indebtedness.

(2) To the extent that the hedging transactions are in fact qualifying hedges of the type identified, the hedging identification statement placed in Taxpayer's books and records on Date 1, as supplemented, will be treated as satisfying the identification requirements of § 1221 and § 1.1221-2(f) for aggregate hedges entered into on or after Date 1, and on or prior to Date 2.

(3) Taxpayer is not precluded by the singular use of the term "liability" in § 475(b)(1)(C)(ii) from identifying as exempt under § 475(b)(2) otherwise qualifying hedges of "liabilities" which are not securities in the hands of Taxpayer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed herein on whether the hedges in question are (i) qualifying tax hedges, (ii) aggregate hedges in fact, or (iii) liability hedges alone or in fact. No opinion is expressed herein on the application of § 1.1221-2(g). No opinion is expressed on the application of any language in § 475 other than the language of § 475(b)(1)(C)(ii). No opinion is expressed on the application of the recordkeeping or substantive rules of § 1.446-4, including whether those rules require mark-to-market accounting for aggregate or specifically identified hedges. No opinion is expressed on the application of § 988.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Patrick E. White
Senior Counsel, Branch 1
(Financial Institutions & Products)

Enclosures:

Copy of this letter

Copy for § 6110 purposes